

S. HRG. 108-648

REVIEW COMMODITY FUTURES TRADING COMMISSION REGULATORY ISSUES

HEARING BEFORE THE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY UNITED STATES SENATE

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REVIEWING COMMODITY FUTURES TRADING COMMISSION REGULATORY ISSUES

THURSDAY, MAY 13, 2004

U.S. SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY,
Washington, DC

The committee met, pursuant to notice, at 10:05 a.m., in room SD-106, Dirksen Senate Office Building, Hon. Thad Cochran [Chairman of the Committee] presiding.

Present or submitting a statement: Senators Cochran, Fitzgerald, Chambliss, Crapo, Harkin, and Conrad.

STATEMENT OF HON. THAD COCHRAN, A U.S. SENATOR FROM MISSISSIPPI, CHAIRMAN, COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

The CHAIRMAN. Good morning. Welcome to the Committee's meeting to review regulatory issues that are under the jurisdiction of the Commodity Futures Trading Commission. This commission regulates commodities futures markets including futures and options on agricultural, energy, and metal commodities, as well as on financial instruments such as interest rates and foreign currencies. The volume and value of exchange-traded futures and options and off-exchange or over-the-counter derivatives have grown tremendously in recent years. These markets play an important price discovery role and risk management role by helping market participants manage financial risk across a wide array of products and services.

In recent years, the Federal Government has modified its regulatory approach in response to the growth and development of these markets. Largely following recommendations of the President's working group on financial markets published in November 1999, the Commodities Futures Modernization Act of 2000 moved away from a one-size-fits-all regulatory approach to a more flexible approach that is based on broad core principles. With the experience of nearly three-and-a-half years since its enactment this is a good time for the Committee to review the impact it is having on the current regulatory environment and the integrity of the commodities futures markets.

To help us with that review I am pleased to welcome James E. Newsome, who is chairman of the commission, as our witness today. Jim Newsome is widely respected for his thoughtful and common sense leadership at the Commodity Futures Trading Commission.

A native of Plant City, Florida, Jim received his B.S. degree in food and resource economics from the University of Florida and his M.S. and Ph.D. degrees in animal science and agricultural economics from Mississippi State University. Dr. Newsome served as executive vice president of the Mississippi Cattlemen's Association before joining the CFTC. He began serving as a commissioner on August 10, 1998 and was nominated by President Bush and confirmed by the Senate to serve as chairman of the CFTC on December 20, 2001.

We appreciate very much your distinguished service and your presence before our Committee for this hearing today. You may proceed.

STATEMENT OF JAMES E. NEWSOME, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, DC

Mr. NEWSOME. Thank you very much, Chairman Cochran. I appreciate the opportunity to testify before you today on behalf of the Commodity Futures Trading Commission. I have submitted a more detailed statement for the hearing record which I will summarize for you this morning.

Before I get started I would like to acknowledge my colleagues that are here today, Commissioners Walt Lukken and Sharon Brown-Hruska, and thank them for their continued support, leadership and hard work at the commission, as well as I would like to recognize Barbara Holum, who retired from the CFTC at the end of 2003 after serving 10 dedicated years as a commissioner.

Mr. Chairman, you instructed that the purpose of this hearing is to update the Committee on the regulatory issues before the commission. To put things into context, I would like to begin by providing you with an overview of our progress in implementing the Commodity Futures Modernization Act of 2000, or the CFMA, which significantly amended the Commodity Exchange Act, and describe how the markets have evolved in response to that very important legislation.

In recognition of several aspects, including the growing importance of the futures and options markets to the domestic and global economies, the need to lift restraints on the ability of exchanges to keep pace with rapidly developing technological advances, and to respond quickly to demands for new products, in the year 2000 under the leadership of this Committee Congress rejected the one-size-fits-all approach to regulation by passing the CFMA. The CFMA amended the Commodity Exchange Act to establish a structure which markets can choose to operate under varying levels of commission oversight, depending on the products traded, the type of system in which they are traded, and the sophistication of market participants. Under this regulatory framework, exchanges are subject to broad core principles governing operational integrity rather than prescriptive rules.

Over the three-and-a-half years since the CFMA was signed into law, the commission has concentrated its efforts on redesigning its regulatory programs to achieve the objectives of the statute. Our first task was to modernize the rules regarding trading facilities, both traditional and the new exempt markets permitted by the CFMA, and to establish guidance for new applicants in existing ex-

changes on how to comply with the core principles. We also studied through hearings, roundtables and the solicitation of public comment our regulations related to futures commission merchants, or FCMs, commodity pool operators, and other futures market intermediaries, to identify areas where improvements could be made and where matters could be delegated to the National Futures Association.

We devoted much of last year implementing a number of modernizations in this area ranging from registration relief for operators of certain pooled investment vehicles that restrict participation to sufficiently well-sophisticated persons, to affording FCMs greater operational flexibility so that they can provide their customers with more efficient trade executions. In both of those endeavors the Commission's goal was to streamline and eliminate regulations where appropriate while keeping important market integrity and customer protections in place. It was hoped that these reforms would, among other things, encourage innovation by existing exchanges and market participants and lower the regulatory costs for new entry into the market, which in turn would result in a heightened level of competition that would benefit the marketplace as a whole. The indications thus far have been very positive.

Some numbers will illustrate my point. In the short period since passage of the CFMA, the commission has approved eight new exchanges as designated contract markets, has accepted the registrations of seven derivatives clearing organizations, some of which were existing clearinghouses serving other financial market sectors, and several that were entirely new organizations not previously affiliated with any particular trading facility.

In addition, the commission has received notices from 13 new ventures of their intent to operate exempt markets, three as exempt boards of trade and 10 as exempt commercial markets. Domestic futures and options volume has almost doubled over the last several years and reached over one billion contracts traded in 2003. New contract filings have increased more than 500 percent during this time period, and the regulatory delay in listing the products after filing has dropped from an average of almost 70 days in 1998 to 1 day for 99 percent of the new contract listed last year due to the certification procedures now available to the exchanges through the CFMA.

Relationships between exchanges and clearinghouses have shifted, leading to market-driven clearing alliances. Certain over-the-counter business is also now cleared, adding an important element of safety and soundness to this important sector of the economy. New and traditional exchanges alike have embraced technology and electronic trading has soared from less than 10 percent of the total volume in 1998 to almost 50 percent of the total last year, with expectations that this upward trend will continue.

This modernized regulatory environment provided by the CFMA coupled with market demand has yielded more platforms, more choices and more competition than ever before, which has fostered capital efficiencies through new strategic alliances and has resulted in enhanced customer service and lower transactional fees.

Another benefit to the markets and to the public that has resulted from the CFMA was the clarification of the Commission's ju-

risdiction with respect to retail foreign currency, or forex transactions. Following this important clarification in the law, the Commission launched an intensive and aggressive enforcement initiative to root out and prosecute unscrupulous operators of fraudulent forex bucket shops. The Commission also approved rules adopted by the National Futures Association last year that require their forex dealer members to take responsibility for the activities of unregulated solicitors that they may deal with. The Commission continues to work with the NFA and other market participants to identify ways in which our supervision of forex activity may be improved.

Since the passage of the CFMA, the Commission has filed 61 enforcement actions in the forex area and has been awarded civil monetary penalties totaling over \$100 million as well as restitutions and disgorgement judgments totaling more than \$62 million. Many of these cases have resulted in additional criminal charges through the cooperative efforts of our division of enforcement and State and Federal criminal authorities.

The Commission has also aggressively pursued those who manipulated or attempted to manipulate the energy futures market. Since 2002, the Commission has opened dozens of investigations in this area which has resulted in 17 actions filed against 20 major energy companies and two individuals, and almost \$200 million in civil monetary penalties collected to date. Mr. Chairman, I am happy to report that 97 percent of the energy investigations we opened in 2002 have been resolved.

By moving frontline accountability for how markets operate and what they trade to the marketplace, the Commodity Exchange Act as amended by the CFMA, permits regulatory resources to be refocused on strong oversight, risk-based inspection, and swift and sure enforcement. It has been an exciting time to be at the Commission and the futures industry as it has evolved and grown over the last several years. In my opinion, the new regulatory framework brought about by the enactment of the CFMA has provided the intended results and has been a success. I would hope, therefore, that as reauthorization approaches any legislative amendments that may be considered be approached cautiously and pursued only after a full debate by all interested parties. The Commission looks forward to working with the Committee on that upcoming project.

I like to close, Mr. Chairman, by expressing how proud I am of the dedicated men and women that work at the Commission who have worked tirelessly over the last three-and-a-half years to modernize our regulatory framework to achieve the goals expressed by this committee and by the Congress, and to timely process the many new exchange and clearinghouse applications we have received. We worked very hard to try and get things right.

Mr. Chairman, I thank you for the opportunity to testify before this committee and certainly am happy to answer any questions.

The CHAIRMAN. Thank you very much, Mr. Chairman, for your presence here and your continued diligent leadership at the Commodity Futures Trading Commission.

Let me ask you the first question and then I am pleased to yield to other Senators who have joined our hearing. You mentioned

changes that have been made under the Commodity Futures Modernization Act. It seems that this has been a success in terms of the growth of the markets, the strength of the markets. Is that an accurate impression? Do you think that the modernization act has contributed to the growth of the markets?

Mr. NEWSOME. It has contributed greatly to the growth and expansion that we have seen in the marketplace over the last several years. Of course there are a number of factors that can be attributed to this growth, but certainly the flexibility that can be attributed to the Act to allow the marketplace to adapt to technology, to make business decisions on a quicker basis as compared to the CEA before the Commodity Futures Modernization Act is a big cause of the success and growth that we have seen in these markets.

The CHAIRMAN. Let me ask you a follow up. Do you think the CFTC needs any additional authority, legal authority under the statute or resources to fulfill your regulatory responsibilities?

Mr. NEWSOME. As we look at the two parts of that question I will address the authority to start with. One of the things that was so positive about the new Act was that it gave the Commission tremendous flexibility. This committee and the Congress realized that these markets were changing rapidly and growing, that the exchanges and market participants had the need to adapt to new technology that was ever-changing. The flexibility that was provided to market participants was also provided to the CFTC so that we could adapt to changes in the marketplace. The flexible authority that was provided to us through the CFMA was very useful to us.

In terms of looking at new rules, at this point I do not see that there is any new authority that is needed by the Commission. In terms of looking at our enforcement authority, the Commission enjoys very broad authority as it relates to the protection of customers through anti-fraud and anti-manipulation provisions. They are always things that we are looking for to help strengthen that enforcement authority which we use as the primary preventive measure to wrongdoing in the marketplace. As we get into reauthorization I would love to sit down and look at what it may be some minor things.

In answer to your question, we feel that we have very ample authority from both the rule and enforcement standpoint.

As we look at resources, the marketplace has grown very rapidly. The CFTC has been an excellent place to work. We have very dedicated employees and staff at the CFTC. Ideally we look at a number of around 550 or the mid-500's in terms of FTEs, is probably an ideal number for us. We are a bit below that right now, but that is because of choices that we made internally. We were very fortunate from Congress last year in that we were one of the few non-defense agencies that got an increase in our budget. We chose to use that increase to fund pay parity of which this committee and Congress also provided for us. I would say that pay parity has achieved its goal. We have stemmed the tide of people leaving the Commission to go to sister agencies so that has worked very, very nicely.

The CHAIRMAN. Thank you very much. I am pleased to yield to my friend and distinguished colleague from North Dakota, Senator Conrad.

Senator CONRAD. Thank you very much, Mr. Chairman. Thank you for holding this hearing, and thank you for the role you played in getting Mr. Newsome as the chairman at CFTC. By all accounts, Mr. Newsome, you are doing an exceptionally good job there. Sometimes people come up here and we give them a going over, which sometimes is richly deserved. Not so often we say, job well done. From all reports you are a steady hand at the helm of the CFTC and we ought to commend you publicly for what you have done to help turn that agency around. It was in considerable turmoil, all of us know, and we appreciate what you have done to provide a steady hand there.

Mr. NEWSOME. Thank you, sir.

Senator CONRAD. A couple questions. By the way, I noticed this article in Stocks Futures in the Options magazine about you. You were their honoree in 2003, and the headline on the article was, Speak Softly and Carry a Big Stick. That is the tradition of Teddy Roosevelt who, as you know, had a ranch in my home State of North Dakota, who we are going to be honoring tomorrow in North Dakota announcing a coin that will be struck in his honor. He was known for speaking softly and carrying a big stick, so I am glad to see you are in that tradition, Mr. Chairman.

A couple of quick questions if I could, Mr. Chairman. On the mad cow case from December that involved the cow from Canada, I understand that there were reports that the CFTC was investigating whether there were some that traded on inside information prior to USDA's public announcement. I heard that when I held a hearing in North Dakota from ranching interests in my State in a hearing that was held in January. I would be interested if you have conducted such an investigation, and if so, is it complete and what are the findings?

Mr. NEWSOME. Anything that happens in our futures market that is wrongdoing is very serious to us, but as a cattleman I pay particularly close attention to the cattle markets. Anytime there is the potential or alleged wrongdoing within the live cattle markets it is something that not only the Commission looks at closely but something that I take a personal interest in.

We take very seriously allegations of leaked information or people trading upon the information. That is something that we are looking at. In fact we are cooperating with the U.S. Attorney's Office for the District of Columbia on this investigation. The investigation is ongoing so I am very limited in terms of what I can say there. We do hope to finish that investigation up this summer.

Senator CONRAD. I appreciate that. I would say this to you, Mr. Chairman. Ranchers in my State brought to the hearing, reports of unusual price movement before the USDA announcement. I must say it raised concern in my eyes of what happened. They had very carefully charted price movements before the official announcement, and those price movements were clearly in one direction and they were clearly unusual.

I hope very much that in fact this investigation is able to report to us what happened. Was there a leaked report or were people

simply anticipating? Did they have wind some way that USDA was going to make a determination? Because that really cannot be tolerated. That is the kind of thing that throws the credibility of the markets in question.

A second quick question if I could, Mr. Chairman, is on the question of international regulation. Your prepared statement describes how futures markets have become truly global in nature. We all see that. We see the movement very rapidly through electronic means of the flow of funds. I am interested in whether or not the CFTC has attempted to assess whether other nations have appropriate regulatory structures in place. More to the point, whether some kind of market meltdown overseas could affect our markets here.

Mr. NEWSOME. The international arena and rules and regulations in foreign jurisdictions are something that we spend a lot of time assessing and working with. We are members of the International Organization of Security Regulators as is the U.S. SEC, and we meet regularly with the goal of looking at rules and regulations, enforcement authorities in jurisdictions all around the globe in coming up with core principles that each jurisdiction can abide by, recognizing that differences in laws and differences in backgrounds lead to more specific rules and regulations within any jurisdiction. Through IOSCO we work very hard to establish certain core principles that every financial jurisdiction around the globe can live by.

We are participants in numerous memorandums of understanding with foreign jurisdictions for the need to share information, particularly with regard to enforcement. If there is wrongdoing within other jurisdictions that have had a negative impact on U.S. customers, we want to have the ability to get the information that we need and to work with our sister jurisdictions to bring charges if they are warranted. In most financial jurisdictions around the world we have very good working relationships. Those relationships are formalized through these MOUs and we are very comfortable that we can receive information and work with these other jurisdictions to bring enforcement actions if necessary, and we have used those MOUs to do just that in the past.

With regard to a meltdown in other jurisdictions, that is something that we continually work on as well. As we look at this globalized market, I would use the example of the London clearinghouse which we recently designated as a designated clearing organization in the U.S. As a DCO registered by us, they are subject to the exact same rules and regulations of any clearinghouse that is housed here locally. U.S. customers have the same protection if their money is at the London clearinghouse as they would if it is at the Chicago Mercantile exchange clearinghouse.

Again, we take very seriously the protection of U.S. customers and their funds, and those are things that as we are going through the designation process looking at new market participants we want to make sure that we can protect them to the same extent that we can protect them if their money was here in the U.S.

Senator CONRAD. Let me be very specific, and this will be my final—I know, Mr. Chairman, you want to move on.

I have heard increasingly concerns about the standards in Caribbean banking centers and whether or not there is increasing vulnerability of the entire global system because of a lack of regulation in those Caribbean banking centers, and that there is a concern, a growing concern I am hearing from people in the financial world about derivatives that have very large potential liabilities and the flow of funds through Caribbean banking centers with regard to those kinds of issues. Can you tell us if you have had an opportunity to take a special look at these Caribbean banking centers and whether or not we can be confident that they are being appropriately watched?

Mr. NEWSOME. There is absolutely no question that there are jurisdictions that fail to meet the standards of IOSCO or the standards that we hold in the U.S. We continually look at jurisdictions all around the world, the Caribbean ones included. The pointed thing I could say at this point is that we have good news recently that jurisdictions in the Caribbean are becoming very sensitive about being pointed out as weak and they are asking to come to the table with the major jurisdictions around the world to try and strengthen their financial regulation so that they are not pointed out.

One of the things that we have done through IOSCO is to create blacklists of jurisdictions that fail to meet appropriate standards. Countries who are on that blacklist are uncomfortable in being there.

Senator CONRAD. Could you provide the Committee with that list?

Mr. NEWSOME. Yes, absolutely. I do not have it with me today.

Senator CONRAD. I understand that, but if you could provide us with that. I would just say in conclusion, Mr. Chairman, I would hope that you would take an especially hard look once again at those Caribbean banking centers, because I am told by people who are knowledgeable that there are very grave questions about how closely they are being regulated, how closely they are being watched, and that there are irregularities there that ought to cause concern.

Mr. NEWSOME. We are more than happy to do so.

Senator CONRAD. I also want to recognize Mr. Sobba who is with you, who is a friend of longstanding, formerly with the cattlemen, formally with baseball, and a very good friend. I am glad to see that he is on your staff as well.

Mr. NEWSOME. I am very fortunate to have him as a member of our team.

Senator CONRAD. Thank you.

The CHAIRMAN. Thank you, Senator.

Senator Chambliss.

Senator CHAMBLISS. Thank you, Mr. Chairman. I know Mr. Sobba too, Senator Conrad. You do have a terrific staff, chairman Newsome. Let me just take a minute to commend you also, just like Senator Conrad. You stepped into a tough situation, but nobody could have done a better job. You have been very available to members on both sides of the Capitol and have been willing to work with us on a number of tough issues that you have been facing and I commend you for that.

It is also nice to have somebody out there testifying for whom I do not need an interpreter, so I am pleased from that standpoint too, from the standpoint of where you come from.

I just have one question and that is, one issue that we worked very long and hard with you on, took us several years to complete it, was the pay parity issue. I would like to hear some comments from you for the record about how that pay parity is working relative to your ability to hire and have folks continue to work with you at CFTC.

Mr. NEWSOME. Senator, as you know because we worked very closely with you, very closely with Chairman Cochran on that issue a couple years ago, and from an internal standpoint there was no bigger issue to us because we were almost double the Government average in terms of our turnover of very experienced staff at the Commission leaving and going to sister agencies who were not bound by the standard Government pay. As you know, they are always people in the Government leaving to go to the private sector and that is understandable. When the vast majority of them are leaving to go to sister agencies, that is difficult for us to deal with, particularly when the markets that we oversee are very complex and technical and it is difficult to hire and train people within our area, so that loss was becoming devastating to us.

Since the implementation of pay parity we have now moved below the Government average in terms of turnover, so it has been a big success to us. We have not been able to use it so much from a hiring standpoint yet because of tight resources. In fact we are in the middle of a hiring freeze right now, but my expectation is that when we have the ability to start hiring again that our pay standards will be a huge benefit to us as they have been with retaining key staff.

Senator CHAMBLISS. I am glad to hear that have attempted for the greater appeared during thank you.

Senator CRAPO. Good. I am glad to hear that and again, thanks for the great job you are doing.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Crapo.

Senator CRAPO. Thank you very much, Mr. Chairman, and chairman Newsome, I appreciate your attendance here. I also want to extend my thanks to you for the tremendous work that you are doing. I have appreciated working with you on a number of issues over the years and have found you to be not only very responsive but very capable in helping us to address the critical issues we deal with.

As you know, derivatives is on of the critical issues that I have been very involved in with you, and although we do not have a legislative issue dealing with it immediately before us right now, it is one that is constantly on the radar screen.

I just would like you once again, if you would, to share with me your thoughts about whether you believe that the way that we manage derivatives and the utilization of derivatives in our economy is something that is beneficial to our financial system and something that helps make our economy more resilient.

Mr. NEWSOME. Senator, I am more than happy to. First of all, The importance of derivatives to this economy grows every day. The ability to manage risk becomes more and more important. Obviously we have had that capability in the business sector for a number of years, but finally more and more in the business community are learning not only the benefits of the use of derivatives but how to use those derivatives as a hedge against real risk. Chairman Greenspan has pointed out on numerous occasions the tremendous benefits of derivatives and risk management to the economy and the business sector and that will continue, and it will continue to grow, both on exchange and over-the-counter.

The over-the-counter business has grown very rapidly over the last 10 years, but over the last several years the exchange-traded growth has been outstanding. I mentioned earlier that over roughly a 4-year period we have seen volume in on-exchange futures and options business double to the point that over a billion contracts were traded last year. There is no question that these products and these contracts are a tremendous benefit.

The regulatory structure in the United States through the passage of Commodity Futures Modernization Act reaches an appropriate balance, a balance between giving businesses, exchanges and firms the flexibility to be creative and somewhat unencumbered by the Government as they develop business plans that are best for them and their customers versus the very strong enforcement approach that we have taken as the deterrent to wrongdoing versus lots of prescriptive rules. It is an exciting time to be in this business. The Commodity Futures Modernization Act was the right legislation at the right time. This committee and the Congress should be commended for your foresight in allowing that shift in the regulatory landscape because it has played a big role in the growth within the futures and derivatives business.

Senator CRAPO. Thank you. I share your feelings about that and appreciate your work with us as we have dealt with these issues over the last little while.

Just other question at that is, the legal certainty provisions in the Commodity Futures Modernization Act were intended by Congress both to reduce the systemic risk and to promote financial innovation. That overall we have achieved both of those objectives through the Act. The one issue, which I am sure you are aware that we are still working on is the passage of the financial contracts netting provisions in the pending bankruptcy bill. Now these provisions clarify the enforceability of early termination and netting of financial contracts that were proposed by the President's Working Group on which you are serving.

Would you please comment on the importance of the netting legislation? Specifically, do you think that it is advisable to separate the netting provision from the broader bankruptcy legislation and pass it separately in the Senate and the House to get to the President as soon as possible?

Mr. NEWSOME. Senator, I am very supportive of that netting provision. In fact I have written to the Congress on three different occasions now, twice as a member of the President's working group and one, along with Pat Wood chairman of the FERC, to support

the netting provision. There is no question in my mind that everything we can do to achieve legal certainty is beneficial and positive.

I understand that as a portion of broader legislation, the netting provision has been non-controversial and has been supported by a wide range of Members of Congress on both sides of the aisle. In my estimation, whether it remains a part of a broader package or whether it is pulled out and passed on its own, it is important to do so and I would be supportive of that.

Senator CRAPO. Thank you very much.

The CHAIRMAN. Thank you, Senator.

Senator Fitzgerald.

Senator FITZGERALD. Mr. Chairman, thank you and thank you for holding this hearing.

Chairman Newsome, thank you for being here and I will add my applause to the long list that has been given for the job you have been doing at the commission. We really appreciate your help and hard work.

I wanted to follow-up on what Senator Crapo asked you about. Maybe I am in a minority on this committee with respect to one issue as to whether or not the CFTC should have jurisdiction in the next CFMA that we do. I guess it will be coming up after I leave the Senate next year.

It is interesting that the current law provides that derivative contracts are regulated if they deal with tangible goods that have a finite limit to them. We do not to regulate interest rate derivative contracts, for example, that banks trade amongst themselves, or that Fannie Mae or Freddie Mac may hedge its interest rate risk by buying interest rate swaps with Citibank or other large financial institutions. For agricultural commodities, for commodities with a finite quantity we do provide CFTC jurisdiction, with one exception, energy and metals contracts that are traded online. That appeared to me to be a special carve-out for Enron Online.

The assets Enron Online have been bought by USB Warburg I believe, and there is also a company, the Intercontinental Exchange that trades energy and metal contracts online. I have always been curious, what is the public policy rationale for carving out energy and metal contracts that are traded online and saying they cannot be regulated by the CFTC? I do think we saw a lot of wash trades, did we not, on that Enron Online that you ultimately have been able to impose a fine on Enron Online.

Who paid that fine, by the way? Or who is liable for that since Enron has gone bankrupt and they have sold Enron Online?

Mr. NEWSOME. That is in bankruptcy court as we speak.

Senator FITZGERALD. You did try to assess the fine on Enron?

Mr. NEWSOME. They have agreed to a settlement of \$35 million and that settlement itself is in front of the bankruptcy court now.

Senator FITZGERALD. Did they challenge your ability to assess that fine?

Mr. NEWSOME. No, the bankruptcy judge has not ruled yet with regard to that settlement with Enron.

Senator FITZGERALD. We do not know, it is not yet shown whether you even have the authority to impose that fine in that case where they were clearly just engaging in a lot of wash trades, sometimes amongst themselves, Enron trading with its own sub-

sidies to set an artificial price or to artificially boost their own revenues. They were claiming all the revenues as revenues of their company even though they were all washed out with an equivalent sale. Enron claimed to be the seventh largest company in America. Really a lot of it was just wash trades through Enron Online.

Mr. NEWSOME. Enron has agreed to the settlement and it is my understanding that the settlement is in front of the bankruptcy court not to decide whether it is a legitimate settlement but to determine where it is in the line with what will be paid and what will not be paid. Enron has agreed with our authority in this area and agreed to that \$35 million. Whether or not any of that money will ever flow to the U.S. Treasury or not is the question.

Senator FITZGERALD. Now in the President's Working Group, in their policy paper they put out before we drafted the last CFMA they said that tangible commodities with a finite quantity should be subject to the CFTC's jurisdiction. They did not mention a special carve-out for energy and metal contracts traded on an online exchange. Do you believe the President's Working Group will this year put out a new policy paper calling for this special carve-out for energy and metal contracts online? If so, what would be the public policy rationale for separating energy and metal and saying that they do not have to be regulated if they are traded online, but if we trade anything else that is a tangible commodity with a finite quantity online we have to have some degree of regulation?

Mr. NEWSOME. In terms of the President's Working Group and any kind of a policy statement, that has not been on the agenda in quite some time. At least at this point, to my knowledge, there is nothing being done to change or adopt a new policy statement on behalf of the PWG.

A couple of years ago after the collapse of Enron, we had a hearing in front of this committee and there were two fundamental questions that were laid on the table. One was, should the over-the-counter marketplace be regulated more similarly to the exchange-traded marketplace? I told this committee at that time that I did not think that it should and, Senator, I feel the same way today.

When we look at the anti-fraud, and anti-manipulation provisions of the act that are provided to the CFTC to deal the wrongdoing in that area, that was the second part of the discussion we had that day was whether or not the CFTC actually has the authority to go after wrongdoing in this area. I hope with the number of cases that we brought and the settlements over the last couple of years that we have settled that question, because at least that it is clear that we do have the ample authority to go after wrongdoing in that marketplace.

In terms of the oversight regulation, while there have been attempts by the Congress to address that, in my opinion the marketplaces are so very different in terms of the participants, the technology, the sophistication that it would be extremely difficult to try and take the type of regulatory oversight that we provide in an exchange-traded market and lay that over the electronic market that you mentioned, for a couple of fundamental reasons. The largest of which, the contracts traded on exchange, as you well know, are very standardized. The pricing information that we get from those

contracts that are transparent is very meaningful because everyone understands what the overlying terms and conditions of the contracts are, and the contracts are set up as such so that the only thing you have to worry about when you are trading is the price. You know all the underlying terms and conditions.

In the over-the-counter market that is not necessarily the case. My fear has been that if you tried to take the large trader reports that we use so successfully in the on-exchange market and get daily pricing information and position information from the over-the-counter marketplace, because the underlying terms and conditions of the contracts are different, that that pricing information, without knowing all the underlying terms, can actually have a negative impact upon the very markets we rely upon for price discovery.

What we are doing, and again from the enforcement standpoint we maintain that we have appropriate anti-fraud, anti-manipulation authority. The one area that is of concern and has been a concern to this committee and it is a concern to us is when a market, if an over-the-counter market gets to a point in terms of size, in terms of standardization that it has contracts that begin to serve a price discovery role, then certainly it is in the public good for that information to become more transparent. We are finalizing rules now that would allow for that transparency if the Commission makes a determination that a market has become a price discovery market, or its contracts are used in a price discovery role. That would include making the prices, daily volume, contracts, all transparent to the public as well as any other information that the commission determines we think would be useful.

Senator FITZGERALD. I know my other colleagues have questions. One final question, Mr. Chairman.

I understand that you are conducting a review of the self-regulatory framework that we have, and I know that you have not released your report yet. Would you have any preliminary observations or thoughts on the results of the study you are undertaking and the effectiveness of our system of self-regulation both on the exchanges and with outside associations that have been set up to offer their services as a regulator, self-regulator?

Mr. NEWSOME. Yes, sir, I would be more than happy to. I would initially say that I announced our review of the self-regulatory structure prior to information being made public on the security side that created quite the uproar there. We did not start our review based upon anything negative happening or as a response to a crisis. I simply felt that for 20 years our SRO structure in the futures business has worked very well. It had been 20 years since we had looked at it, and a lot of changes have taken place in the business with new market participants, new technology, and I felt that it was appropriate for us to conduct a review to make sure that the SRO structure continued to work as effectively today as it did when it was implemented.

I am happy to say that we continue to believe that our SRO structure works very, very well and provides the kind of protections to the marketplace and the customers that we all expect that it should. We are continually that review. We hope to finish it within a matter of a couple of months. My expectation is that we are not

going to need to make very broad changes to the SRO structure because for the most part it continues to work extremely well.

There are some areas that we can make some recommendations in to strengthen the SRO structure but it continues to work fine.

Senator FITZGERALD. Thank you. That is very helpful. Will you release a report on that? Will it be published?

Mr. NEWSOME. Yes, sir.

Senator FITZGERALD. We will look forward to that.

Mr. Chairman, again thank you for doing this hearing. Chairman Newsome, thank you for being with us.

The CHAIRMAN. Thank you, Senator Fitzgerald.

Senator Harkin.

Senator HARKIN. Thank you very much, Mr. Chairman. Again I apologize to you and the others for arriving late and I appreciate the opportunity to just make a short statement and ask chairman Newsome a couple of questions.

First I would just like to commend Mr. Newsome on his work as chairman of CFTC implementing the Commodity Futures Modernization Act and pursuing enforcement actions against people who violate it. I have also appreciated the responsiveness of the CFTC to concerns raised by members of this committee.

I continue to be concerned about whether the CFTC has really adequate authority to oversee energy markets. I know a lot has been discussed here about that. Energy swaps and derivatives have a far more direct linkage to consumer pocketbooks than other exempt commodities such as metals. I believe the 16 energy enforcement cases settled by the CFTC so far for over \$200 million in fines demonstrates that the CFTC has the authority to punish wrongdoing and the commission is using that authority.

However, we need to make sure that the Federal agencies have the tools needed to detect and prevent the abuses from occurring in the first place, and I will have a question about that, especially given the fallout that it has for consumers. I also believe the Committee needs to take a look at the impact that increased global clearing links may have on the CFTC's ability to regulate the U.S. derivatives markets. I know that Eurex has applied for approval of such a link. I have had people in talking to me about that. I guess the CFTC is currently considering that application.

Increased global clearing could portend a significant change in the structure of our U.S. derivatives markets. I do not know that we fully understand what the ramifications of that might be but we ought to be thinking about what the ramifications of that would be.

Mr. Newsome, I just have three questions. First, do you believe being short two commissioners is hampering the ability of the CFTC operate effectively?

Mr. NEWSOME. No, sir, I do not. I would quickly say that the commission operates best when all the seats are full and we are able to share the ideas and thoughts of a full commission. From an operational standpoint having two empty seats has not impeded our ability to operate and do business.

Senator HARKIN. Mr. Chairman, it seems to me to me if that is the answer of Mr. Newsome, then I see no reason why we have to continue with five. We ought to legislatively reduce the number of commissioners to three. We ought to save the taxpayers some

money. If the Commission can operate with three—and that is what you just said—and it does not hamper your ability, I will be introducing legislation, and I hope this committee will consider this year reducing it down to three, two of one party and one of another. Obviously, if we do not need five, why have them? I guess that is it.

Now I must say that we have two names down at the White House now. They have been sitting on them for over a year. The basic paperwork to move them has stalled; has not even begun. I always thought this was unfortunate for the Commission. If the commission can operate with three we ought to do it with three. We will save the taxpayers some money.

Thank you, Mr. Newsome, we will just see if we can reduce that down to three then. This is one commissioner up this year. Obviously, we will not approve that commissioner to be extended. That will be the end of it right there. I can tell you, this is one Senator that will make sure that this person is not extended and we will get two of one party and one of another, regardless of who is President of the United States.

I understand the CFTC and FERC have brought several enforcement cases regarding illegal activities in the energy markets. Again, pertaining to what I said earlier, I want to know how can we do a better job of preventing the abuses in the energy derivatives markets, not just going after them once it has happened. How do we prevent it? It seems that surveillance and continuous oversight are the hallmarks of successful programs that detect and address abuses early. How can the CFTC do this for exempt commodities like energy, for example, derivative products? How can we promote more transparency and openness in the energy markets?

It is one thing to be able to go after them after it has happened, but it seems to me if we really want to protect consumers we have to have some way of preventing these in the first place. Any thoughts on that?

Mr. NEWSOME. Yes, sir, and I appreciate you bringing that point up, because there are several areas that deserve discussion. When the Enron collapse happened, the Commodity Futures Modernization Act was almost brand new so a lot of the Act we had not had an opportunity to utilize. A very important part of the Act was that strong, swift enforcement was hoped that it would serve as a deterrent to wrongdoing in the marketplace. We have tried to use that enforcement authority as aggressively as we know how to use it, Senator, to bring charges against wrongdoers within this marketplace.

The activity is just one of the prongs in the wheel. We have cooperated and worked very closely with the Federal Energy Regulatory Commission that has primary responsibility in the cash markets. We worked very closely with the SEC. We worked very closely with the Justice Department, all as a part of the corporate fraud task force to cooperate together, to share information where we could, to bring the charges that all the agencies have brought over the last 2 years. It is my hope that since the Act was new, we had not had an opportunity to use it, the fact that we have used our enforcement authority as aggressively as we can will serve as a deterrent to wrongdoing in the future.

I know that we have spent quite a bit of time with FERC, and not only their staff but their commissioners have been to our office to look at our surveillance of the futures markets and the type of information that we provide and look at on a weekly basis. They are in the process of implementing a surveillance system themselves in the cash marketplace so that they hope that the information that is provided to them in the cash markets, as the information that is provided to us in futures markets, can serve as a deterrent to wrongdoing in the future as well.

Senator HARKIN. Do you think that would be adequate?

Mr. NEWSOME. Yes, sir, I do.

Senator HARKIN. I am not so certain I agree with you on that. It might be a step in the right direction. It might help, but I am not sure that that alone would be adequate, but we might discuss that later on.

The last thing I want to just—and I do not mean to prolong the hearing, Mr. Chairman, but what I said about Eurex's application in my statement, that Eurex has applied before approval of a link, a global clearing link. If that has been discussed earlier I do not want to go over it again, but just tell us how you are thinking about approaching this? What does that portend for our derivatives markets here, how that is going to change things if that is approved?

Mr. NEWSOME. That is a timely question because the Commission is reviewing that process and information today, particularly with regard to the Eurex application, so there are probably still more questions and answers at this point. We take very seriously our charge to protect customers and their funds. It has been our stance that if there is to be a clearing link in which U.S. customer's funds could be placed in another jurisdictional clearinghouse, that we want to make sure that they are offered the same types of protections that they have here in the U.S. The way to do so is to require that if these types of clearing links are set up in which there is equal flow of customer funds back and forth that in most circumstances they are required to register as a designated clearing organization with the CFTC.

We do have some history with regard to these types of clearing links. The Chicago Mercantile Exchange has a formal plan with Singapore that is somewhat shy of being a clearing link in the context of what you asked about with Eurex. We just designated the London clearinghouse as a derivatives clearing organization. One of the things that comes about by that designation is that U.S. customer funds are protected just as much as if they are in the London clearinghouse as they are if they are at the clearing corporation in Chicago. They are offered the same rules and protections in either instance.

It is our expectation now, based upon the business plan that Eurex has offered, that most likely they will be required to register as a designated clearing organization as well. If that is the case, then customers are just as protected as if their funds were in a clearinghouse here.

Senator HARKIN. That is nice to know.

One last thing. I was asked this question this morning. Some in the farm community feel there was an announcement or a leak by

the Bunge Corporation during the trading day. This has to do with soybean, soybean futures.

It is lawful or appropriate for a company to make an announcement or put information out while the market is open? It is lawful to trade or take a market position and then release information that would move the market? Could the managed release of information constitute market manipulation? These are all things were asked about what Bunge did. They are so big and they made this announcement during the trading day and there is a lot of concern. Is it lawful for them to do that during the trading day?

Mr. NEWSOME. Yes, sir. The futures markets operate on information and, obviously, fundamental information about the marketplace can move the markets. I am aware of the major move in soybeans yesterday. Our surveillance economists are currently looking at the information that was available in the marketplace yesterday to make a determination of whether or not the market moved based upon fundamentals or whether there was something else involved. We have just started looking at that so I have very few details that I could provide this morning.

Senator HARKIN. Would you please keep this committee advised and informed as you find this information out?

Mr. NEWSOME. Yes, sir.

Senator HARKIN. I also again want to know—the other question I want answered is, it is lawful for a company of the size of Bunge to take a market position and then release information that they know will move the market, because they are so big? You see what I am saying?

Mr. NEWSOME. Yes, sir.

Senator HARKIN. They take a market position, then they release the information which moves the market.

Mr. NEWSOME. It is lawful for them to do so. Obviously, as a big grain company they know their business plans and what kind of risk that they have to manage, so we would be logical within the marketplace for them to take a position to try and manage that risk.

Typically in the market, even without them announcing it, as people see them starting to move in a particular direction or starting to take particular positions, the others in the pit figure out quite quickly that something is going on and they react to that. That would be relatively normal within the trading pits.

Senator HARKIN. Thank you. Thank you very much, Mr. Newsome.

Thank you, Mr. Chairman.

Again, I just want to repeat for emphasis sake that it looks like we are on the road to having three commissioners, which if that works, that is fine; we save the taxpayers some money. I just want to make it clear that if that is the case then whoever is up—I guess there is a vacancy this year—I will use my position to make sure that that person is not reappointed and that we have a balance re-instituted with two and one.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator, for your participation in the hearing.

Mr. Chairman, let me ask you about the enforcement record of the Commission with respect to the energy area. Several senators have brought that up this morning and it is important for us to include in the record, if you can help us in this respect, a list or a summary of the enforcement actions that have been taken by the commission on energy trading and that general area that has been the subject of some questions this morning. I hope it will show us clearly whether or not the commission has been able to use its authority under the law to punish, through fines or other sanctions, wrongdoing in this area by energy traders.

Is that possible for you to be able to provide that for the record, or do you have a written summary of that that can be provided to the Committee this morning?

Mr. NEWSOME. I do not have a summary in front of me, Mr. Chairman, but I can very easily provide you with a list of all the companies and the sanctions and the fines within the energy sector that we have brought thus far and would be more than happy to do so.

The CHAIRMAN. It is probably human nature to assume that in the lawmaking process that we have the power to prevent lawbreaking by passing a law. What we can do is punish those who break the laws, but it is very difficult to legislate no wrongdoing in a certain area, by an industry or by individuals. It is an interesting challenge that we face. Just by giving a Federal agency or a Commission such as the CFTC power to regulate an industry or an activity, does not mean that we endow you with a power to prevent wrongdoing. You agree with that as a general approach to the power of lawmakers and regulators?

Mr. NEWSOME. I agree completely with that. It was clear to me that under the CFMA that the strong and broad enforcement authority that is provided to the commission was to be used as a deterrent to wrongdoing in these markets. We have taken that charge seriously and we have used our enforcement authority as aggressively as we can to try and prevent wrongdoing in the future.

The CHAIRMAN. How would you assess the effectiveness of the actions by the commission in acting as a deterrent or having your actions act as a deterrent? Do you have, on the basis of your observations during your term as chairman of the Commission, any opinions about whether that has been an effective deterrent?

Mr. NEWSOME. To this point it has, but time will be the great determiner of whether or not it has had a real deterrent. I do know that our aggressive activity in the enforcement area has created lots of changes within the energy OTC business. Those that are still involved in this business have made great changes to their business plans, the way that they trade, the way that they conduct themselves. We have even seen a number of the companies get out completely of the energy trading business. That was somewhat hurtful to the business for a while because credit availability was slim, liquidity dried up in many areas.

That leads me to another point in the Act in terms of clearing over-the-counter contracts. The Act envisioned that. The Commission has allowed it, and now we have quite active clearing of over-the-counter energy markets.

Anyway, back to the original point, a lot of changes have taken place. A lot of the major banks have stepped in to fill the void that energy companies that exited the market created and now we are seeing trading volume and liquidity in the energy area increase with different players and with different business plans. The changes that were made internally by energy companies have been positive.

The CHAIRMAN. Do you think the integrity of the trading business in the energy area has improved over the last year?

Mr. NEWSOME. Yes, sir, I sure do.

The CHAIRMAN. As a direct consequence of the action of this commission?

Mr. NEWSOME. Yes, sir.

The CHAIRMAN. In looking forward next year when we come to the reauthorization process, do you have any early suggestions to make as to areas where we should start our work now thinking about how to improve or make the Act even more effective than it has been in the past?

Mr. NEWSOME. I do not at this point. This is an area that we have just started really thinking about at the Commission and I would simply say that I look forward to working with this committee as we move forward. As we identify or come up with any areas we certainly will be quick to share them with this committee. The CFMA, as you well know, Mr. Chairman, was developed over a 2-year period with very intensive work by this committee and the House Agriculture Committee, continues to serve as well today as it did when it was passed.

The fact that so much time was put on the CFMA and that it is such outstanding legislation, negates the need for very broad-reaching legislation this time around. There may be some areas or some tweaks that can be changed to benefit the act, but I simply look forward to working with this committee as we move forward on it.

The CHAIRMAN. Your advice and counsel is very important for us and your performance has shown that you have brought to the Commission a seriousness of purpose and a calm, thoughtful approach to the responsibilities that have paid off, not only in terms of the effectiveness of the work of the Commission but the restoration of integrity in our markets. I congratulate you for a job well done. We appreciate your service.

Mr. NEWSOME. Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Newsome can be found in the appendix on page 22.]

The CHAIRMAN. With that, our hearing is adjourned.

[Whereupon, at 11:13 a.m., the Committee was adjourned.]

A P P E N D I X

MAY 13, 2004



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Testimony

**Written Testimony of
James E. Newsome, Chairman
Commodity Futures Trading Commission
before the
Committee on Agriculture, Nutrition, and Forestry
United States Senate**

May 13, 2004

Thank you Chairman Cochran, Ranking Member Harkin, and Members of the Committee for the opportunity to testify before you today on behalf of the Commodity Futures Trading Commission ("CFTC" or "Commission"). Before I get started, I would like to acknowledge my colleagues, Commissioners Walt Lukken and Sharon Brown-Hruska, and thank them for their continued support, leadership and hard work, as well as Barbara Holum, who retired from the CFTC last year after serving ten dedicated years as a Commissioner.

The purpose of this hearing is to update you on regulatory issues before the Commission. But, as background, I would first like to describe how the Commission operates. And to put things into context, I would like to provide you with an overview of our progress in implementing the Commodity Futures Modernization Act of 2000 ("CFMA"), which significantly amended the Commodity Exchange Act ("CEA"), and describe how the markets have evolved in response to that landmark legislation.

Background

Congress created the Commission in 1974 to oversee the nation's commodity futures markets. The Commission's mission is twofold: to foster transparent, competitive, and financially sound markets that operate free from manipulation or distortion, and to protect users of those markets from fraud and other abusive practices. Integral to accomplishing its mission are the Commission's two regulatory units devoted to overseeing the day-to-day operations of the markets: (1) the Division of Market Oversight ("DMO"), which is comprised primarily of economists and attorneys who conduct ongoing market surveillance to detect and prevent price distortion and manipulation, process applications from new exchanges, review new contracts and exchange rules for compliance with the CEA, conduct periodic reviews to assess the effectiveness of exchange compliance programs, and monitor the markets for possible trading abuses; and (2) the Division of Clearing and Intermediary Oversight ("DCIO"), which employs auditors, attorneys, and other staff who monitor the financial and operational integrity of clearinghouses and intermediaries to ensure that customer funds are protected and that

safeguards are in place to prevent the financial problems of a single entity from posing systemic risk. Also crucial is the Commission's Division of Enforcement ("Enforcement"), which investigates potential violations of the CEA and prosecutes them when they are found.

Historically, futures contracts were traded primarily on agricultural commodities. These contracts gave farmers, ranchers, distributors, and users of everything from corn to cattle an efficient and effective set of tools to handle the price volatility often experienced in agricultural markets. As time passed, however, the risk management benefits of the futures markets became apparent to other sectors of the economy, and exchanges sought to apply the mechanics of futures trading to new products, such as currencies, sovereign debt, metals, and energy. Manufacturers now use futures contracts to fix their raw material costs and reduce uncertainty over the prices they receive for finished products sold overseas. Mutual fund managers can now use stock index futures to protect against market volatility and to effectively put a floor on portfolio losses, and electric power generators can use futures contracts to secure stable pricing for their coal and natural gas needs. Today, while agricultural contracts are traded as actively as ever and continue to grow in volume (the Chicago Board of Trade reported record numbers in its agricultural futures and options complex for the month of April, up 53.6 percent over last April), the vast majority of trading is in financial products. Our most recent statistics show that approximately 9% of futures and options trading is in the agricultural sector, while 54% is in interest rate products such as three-month Eurodollars and ten-year U.S. Treasury Notes, 24% is in equity index products, for example, the S&P 500, 9% is in the energy sector, such as crude oil and natural gas, 3% is in currencies, and 2% is in metals.

Although I have described the primary purpose of the futures markets as a mechanism for risk management, many futures markets play another important role in the economy—that of price discovery. Businesses and investors that may not be direct participants in a particular futures market may nonetheless refer to the quoted prices of certain futures market transactions as reference points or benchmarks for other types of transactions and decisions. This is particularly important in many agricultural markets where no other means of price discovery exist outside the quoted futures prices, but it is also true in other sectors, including many energy markets.

How the CFTC Performs Its Mission

In seeking to fulfill its mission, the Commission focuses on issues of integrity. We seek to protect the *economic integrity* of the futures markets so that they may operate free from manipulation or congestion (for example, an artificial price situation not intentionally caused by market participants). We seek to protect the *financial integrity* of the futures markets so that the insolvency of a single market participant does not become a systemic problem affecting other market participants or financial institutions. We seek to protect the *operational integrity* of the futures markets so that transactions are executed fairly, proper disclosures are made to customers, and fraudulent sales practices are not tolerated. The Commission pursues these goals through a multi-pronged approach to market oversight.

Economic Integrity

The Commission protects against manipulation and congestion by working with exchanges and potential exchanges through reviewing exchange rules and proposed rule changes prior to trading, and applications for designation. Once trading begins in a new or revised contract, the Commission acts through direct market surveillance and by overseeing the surveillance efforts of the exchanges themselves. The heart of the Commission's direct market surveillance program is the large-trader reporting system, under which clearing members of exchanges, futures commission merchants ("FCMs"), and foreign brokers electronically file daily reports with the Commission. These reports show all trader positions above specific reporting levels set by CFTC regulations. Because a trader may carry futures positions through more than one FCM, and because a customer may control more than one account, the Commission routinely collects information that enables its surveillance staff to aggregate information across FCMs and for related accounts.

Using these reports, the Commission's surveillance staff closely monitors the futures and option market activity of all traders whose positions are large enough to potentially effect the orderly operation of a market. For contracts that are settled through physical delivery at expiration—such as energy contracts—staff carefully analyzes the adequacy of potential deliverable supply. In addition, staff monitors futures and cash markets for unusual movements in price relationships, such as cash/futures basis relationships and inter-temporal futures spread relationships, which often provide early indications of potential problems.

The Commissioners and senior staff are kept apprised of market events and potential problems at weekly surveillance meetings and more frequently when needed. At these meetings, surveillance staff briefs the Commission on broad economic and financial developments and on specific market developments in futures and option markets of particular concern.

If indications of attempted manipulation are found, the Commission's Enforcement staff investigates and prosecutes alleged violations of the CEA or Commission regulations. The Commission has available to it a variety of administrative sanctions against wrongdoers, including revocation or suspension of registration, prohibitions on futures trading, cease and desist orders, civil monetary penalties, and restitution orders. The Commission may seek federal court injunctions, restraining orders, asset freezes, receiver appointments, and disgorgement orders. If evidence of criminal activity is found, the Commission may refer matters to state authorities or the Justice Department for prosecution of violations. Those authorities may bring cases under the CEA, or under state or federal criminal statutes such as those prohibiting mail fraud, wire fraud, and conspiracy. Over the years, the Commission has brought numerous enforcement actions and has imposed sanctions against firms and individual traders for manipulating or attempting to manipulate prices, including the well-publicized cases against Sumitomo for alleged manipulation of copper prices and against the Hunt brothers for manipulation of the silver markets. Over the past year-and-a-half, the Commission has filed 16 enforcement actions against 20 major energy companies and two individuals resulting from our investigations in the energy sector, and has collected almost \$200 million in civil monetary penalties to date.

Financial Integrity

In protecting the financial integrity of the futures markets, the Commission's two main priorities are to avoid disruptions to the system for clearing and settling contract obligations, and to protect the funds that customers entrust to FCMs. Clearinghouses and FCMs are the backbone of the exchange system. Together, they work to prevent the financial difficulties of one trader from becoming a systemic problem to other traders. Several aspects of the financial integrity framework help the Commission to achieve these goals with respect to traders: (1) requiring that market participants post margin to secure their ability to fulfill obligations; (2) requiring participants on the losing side of trades to meet their obligations, in cash, through daily (sometimes intraday) margin calls; and (3) requiring FCMs to segregate customer funds from their own funds.

The Commission also works with the exchanges and the National Futures Association ("NFA") to closely monitor the financial condition of the FCMs themselves, which must provide the Commission, exchanges, and the NFA with various monthly, quarterly, and annual financial reports. The exchanges and the NFA also conduct periodic audits and daily financial surveillance of their respective member FCMs. Part of this financial surveillance involves looking at each FCM's exposure to losses from the large customer positions they carry. As an oversight regulator, the Commission reviews the audit and financial surveillance work of the exchanges and the NFA, but also monitors the health of FCMs directly, as appropriate. The Commission also periodically reviews clearinghouse procedures for monitoring risks and protecting customer funds.

As with attempts at manipulation, the Commission's enforcement staff investigates and prosecutes FCMs alleged to have violated financial and capitalization requirements or to have committed other supervisory or compliance failures in connection with the handling of customer business. Such cases can result in substantial remedial changes in the supervisory structures and systems of FCMs and can influence the way particular firms conduct business. This is an important part of fulfilling the Commission's responsibility for ensuring that sound practices are followed by FCMs.

Operational Integrity

Protecting the operational integrity of the futures markets is also accomplished through the requirements that mandate appropriate disclosure and customer account reporting, as well as fair sales and trading practices by registrants. Commission oversight helps to maintain appropriate sales practices by requiring fitness screening of industry professionals, proficiency testing, continuing education, and supervision of these persons. Extensive recordkeeping of all futures transactions is also required. Commission staff reviews compliance with those requirements and other requirements. Finally, the Commission oversees the self-regulatory programs of the exchanges and the NFA through regular reviews.

As with the Commission's efforts to protect the economic and financial integrity of the futures markets, the Commission's Enforcement staff also plays an important role in deterring behavior that could compromise the operational integrity of the markets by investigating a

variety of trade and sales practice abuses that affect customers. For example, the Commission brings actions alleging unlawful trade allocations, trading ahead of customer orders, misappropriating customer funds, and non-competitive trading. The Commission also takes action against unscrupulous commodity professionals who engage in a wide variety of fraudulent sales practices against the public.

Changes in the Futures Markets, Pre and Post-CFMA

Many changes have occurred in the futures markets over the last twenty-five years. As I mentioned earlier, when the CFTC was founded the vast majority of futures trading was based on agricultural commodities, but evolved over time to include a wide variety of products, with financial products predominating today. As these developments occurred, the locations, hours and methods of futures trading also expanded. In the early days of the Commission, trading was largely confined to the U.S. and was done by open outcry during limited daytime hours in exchange trading pits designated by the CFTC as contract markets. Today, trading occurs on traditional exchanges by open outcry and electronically, at new, all-electronic exchanges, and off-exchange entirely. The markets have also become global in nature, with large numbers of foreign traders participating in U.S. markets and vice versa, and with linkages between U.S. exchanges and foreign counterparts operating around the clock.

In recognition of the growing importance of the futures markets to the domestic and global economies, and the need to lift restraints on the ability of exchanges to keep pace with rapidly developing technological advances and to respond quickly to demands for new products, in 2000, under the leadership of this Committee, Congress rejected the one-size-fits-all approach to regulation by passing the CFMA. The CFMA amended the CEA to establish a structure in which markets can choose to operate under varying levels of Commission oversight, depending on the products traded, the type of system in which they are traded, and the sophistication of the market participants. Under this new regulatory framework, exchanges are subject to broad core principles governing operational integrity rather than prescriptive rules. In addition, Congress:

- granted exchanges the ability to list new products and amend contract rules by certifying that they comply with the CEA, rather than having to seek the prior approval of the Commission;
- unbundled the clearing function from the trade execution function and granted the Commission explicit authority over derivatives clearing organizations (“DCOs”), which were authorized to clear both on-exchange and over-the-counter (“OTC”) transactions;
- provided legal certainty for OTC transactions;
- legalized security futures products (“SFPs”); and
- clarified the CFTC’s jurisdiction over retail foreign currency trading.

Over the approximately three-and-a-half years since the CFMA was signed into law, the Commission has concentrated its efforts on redesigning its regulatory programs to achieve the objectives of the statute. Our first task was to modernize the rules regarding trading facilities, both traditional and the new exempt commercial markets and exempt boards of trade permitted by the CFMA, and to establish guidance for new applicants and existing exchanges on how to

comply with the core principles. We also studied, through hearings, roundtables, and the solicitation of public comment, our regulations relating to FCMs, commodity pool operators (“CPOs”) and other futures market intermediaries, to identify areas where improvements could be made and where matters could be delegated to the NFA. We devoted much of last year implementing a number of modernizations in this area ranging from registration relief for operators of certain pooled investment vehicles that restrict participation to sufficiently well sophisticated persons, to affording FCMs greater operational flexibility so that they can provide their customers with more efficient trade executions.

In both of these endeavors the Commission’s goal was to streamline and eliminate regulations where appropriate, while keeping important market integrity and customer protections in place. It was hoped that these reforms would, among other things, encourage innovation by existing exchanges and market participants and lower the regulatory costs for new entry into the markets, which in turn would result in a heightened level of competition that would benefit the marketplace as a whole. The indications thus far are that this is exactly what has happened.

Some numbers will illustrate my point. In the few, short years since passage of the CFMA, the Commission has approved eight new exchanges as designated contract markets and has accepted the registrations of seven DCOs, some of which were existing clearinghouses serving other financial market sectors, and several that were entirely new organizations not previously affiliated with any particular trading facility. In addition, the Commission has received notices from thirteen new ventures of their intent to operate exempt markets, three as exempt boards of trade and ten as exempt commercial markets.

Domestic futures and options volume has almost doubled over the last few years, and reached over one billion contracts traded in 2003. New contract filings have increased more than 500% during this time period, and the regulatory delay in listing the products after filing has dropped from an average of almost 70 days in 1998, to one day for 99% of the new contracts listed last year due to the certification procedures now available to exchanges.

While the number of FCMs has stayed relatively stable—203 at the end of fiscal year 2000 versus 205 at the end of fiscal year 2003—as noted above the amount of contracts and dollar volume traded by FCMs has increased dramatically in the last several years. During the same timeframe, the number of CFTC-registered CPOs and the commodity pools they sponsor, operate, or advise, has grown significantly. At the end of fiscal year 2000, there were 1,624 registered CPOs operating 1,953 commodity pools. These numbers grew to 2,059 CPOs operating 3,244 commodity pools at the end of fiscal year 2003. In 2003, commodity pools held approximately \$450 billion in net assets.

Alliances between exchanges and clearinghouses have shifted leading to market-driven clearing links and common clearing platforms, which provide capital savings through efficiencies such as portfolio margining. Certain OTC business is also now cleared, adding an important element of safety and soundness to this important sector of the economy. New and traditional exchanges alike have embraced technology, and electronic trading has soared from

less than 10% of the total volume in 1998, to almost 50% of the total last year, with expectations that this upward trend will continue.

The interest of foreign entities willing to invest in U.S. markets has also risen. Two U.S. designated contract markets are directly or indirectly owned by European exchanges. A U.K. clearinghouse was approved to clear transactions executed on one of the new U.S. exempt commercial markets, and just this week, the Commission expanded its designation to allow it to clear transactions executed on U.S. designated contract markets. In addition, a U.S. clearinghouse has a request pending that, if approved, would allow U.S. customers to clear, through its clearing members, futures and options traded on a German exchange.

This modernized regulatory environment, coupled with market demand, has yielded more platforms, more choices, and more competition than ever before, which has fostered capital efficiencies through new strategic alliances and has resulted in enhanced customer service and lower transactional fees.

Enforcement Efforts

Another benefit to the markets and to the public that resulted from the CFMA was the clarification of the Commission's jurisdiction with respect to retail foreign currency ("forex") transactions. Prior to the CFMA, the Commission's authority to shut down foreign currency bucket shops had been called into question due to differing court opinions interpreting the scope of the Treasury Amendment, a provision of the CEA which excluded the inter-bank foreign currency market from the Commission's jurisdiction. Recognizing that this had created a gap in the law, Congress granted to the CFTC explicit authority to prosecute illegal, off-exchange forex futures and options offerings to the retail public. Following this important clarification in the law, the Commission launched an intensive enforcement initiative to root out and prosecute unscrupulous operators of fraudulent forex bucket shops. The Commission also approved rules adopted by the NFA last year that require their forex dealer members to take responsibility for the activities of any unregulated solicitors they may deal with. The Commission continues to work with the NFA to identify ways in which our supervision of forex activity may be improved.

Since passage of the CFMA, the Commission has filed 61 enforcement actions in the forex area, and has been awarded civil monetary penalties totaling over \$100 million, as well as restitution and disgorgement judgments totaling more than \$62 million. Many of these cases have resulted in additional criminal charges through the cooperative efforts of our Division of Enforcement and state and federal criminal authorities.

The Commission has also aggressively pursued those who manipulated or attempted to manipulate the energy futures markets. Since 2002, the Commission has opened dozens of investigations in this area, which, as I mentioned earlier, has resulted in 16 actions filed and almost \$200 million in civil monetary penalties collected to date. I am happy to report that 97% of the energy investigations we opened in 2002 have been resolved.

Security Futures Products

Another notable aspect of the CFMA was the legalization of security futures products ("SFPs"), which are futures contracts based on individual stocks or narrow stock indices. The legislation defined SFPs as both futures and securities and directed the CFTC and the Securities and Exchange Commission ("SEC") to share oversight responsibility for their trading under a primary regulator and notice regulator regime intended to avoid duplicative or overly burdensome requirements on market participants. Futures based on broad-based stock indices, which have been permitted since 1982, remain under the exclusive jurisdiction of the CFTC.

Although the two agencies were able to jointly formulate rules that allowed SFPs to begin trading in a timely manner, the products have not been as successful as some had predicted. I believe that this is due in part to the lack of a risk-based portfolio margining regime for SFPs similar to that used in other futures markets. Another issue that remains outstanding is the promulgation of joint rules to permit the trading of foreign SFPs. It is my hope that we can reach agreement with the SEC on these and other issues in the near future.

Ongoing Initiatives

While the major work of implementing the CFMA is done, the Commission continually looks for ways to further the spirit and purposes behind the legislation, to lift regulatory burdens where they no longer serve a legitimate purpose, and to replace obsolete, prescriptive requirements with principles-based oversight that allows for innovation and fair competition. One area in which we are focusing is to modernize our oversight of exchanges, clearinghouses, and other self-regulatory organizations with risk-based examination cycles and risk-focused reviews. Similar to the approach of other federal financial regulators and certain overseas financial supervisors, both the scheduling and scope of the CFTC's supervisory reviews will now be based on careful analysis of the underlying risks to which an institution is exposed and the controls it has in place to address those risks. This approach promises to better utilize staff resources and to facilitate even greater financial integrity and risk management within the firms and clearinghouses that are the backbone of the futures clearing system.

In addition, in keeping with the CFMA's directive that the public interests embodied in the futures markets be served through a system of effective self-regulation of trading facilities, clearing systems, market participants, and market professionals under the Commission's oversight, I announced last year that the Commission would review the roles, responsibilities and capabilities of the industry's self-regulatory organizations ("SROs"). This was not because of any particular concern or perceived problem, but because I thought it was the prudent thing to do given the CFMA's emphasis on self-regulation, and the structural changes occurring in the industry such as the move by exchanges towards demutualization. Since the initiation of the SRO study, Commission staff has interviewed more than 100 individuals representing FCMs, exchanges, and DCOs. Staff has also interviewed industry executives, academics, consultants and individuals associated with securities-side entities.

Based on these interviews, we identified two issues for immediate attention: (1) ensuring the confidentiality of certain information obtained by SROs in the course of their self-regulatory

activities; and (2) examining the cooperative regulatory agreement by which SROs coordinate compliance examinations of FCMs. As part of that review, the Commission recently issued a request for comment on proposed amendments to that agreement. The Commission is also moving forward with a second phase of the study, which will focus on governance issues. A request for comment soliciting views on a number of issues in that area will go out soon.

Conclusion

By moving front-line accountability for how markets operate and what they trade to the marketplace, the CEA, as amended by the CFMA, permits regulatory resources to be refocused on strong oversight, risk-based inspection, and swift and sure enforcement. It has been an exciting time to be at the Commission as the industry has evolved over the last few years to incorporate new technologies into their business models and meet the challenges of competition. In my opinion, the new regulatory framework brought about by enactment of the CFMA has been a success. I would hope, therefore, that as the time for reauthorization approaches, any legislative amendments that may be considered be approached cautiously and pursued only after a full debate by all interested parties. The Commission looks forward to working with the Committee on this upcoming project.

I would like to close by expressing how proud I am of the dedicated men and women at the Commission who have worked tirelessly over the last three-and-a-half years to reshape our regulatory framework to achieve the goals expressed by Congress and to timely process the many new exchange and clearinghouse applications we have received. We have worked very hard to get things right. Thank you for the opportunity to testify. I will be happy to answer any questions you may have.

QUESTIONS AND ANSWERS

MAY 13, 2004

Responses to Questions Raised During the Hearing Requiring Additional Information

In response to Senator Cochran's request during the hearing for a summary of the Commission's enforcement actions in the energy area, the following information is provided:

To date, the Commission has filed 17 major enforcement actions as a result of its ongoing investigation of wrongdoing in the energy markets. These enforcement actions have thus far resulted in civil monetary penalties totaling over \$215 million, among other sanctions.

Energy Enforcement Actions In Litigation

1. *CFTC v. Enron Corp., et al.*, No. H-03-909 (S.D.Tex. filed March 12, 2003) (settled with respect to company - \$35 million civil monetary penalty; litigation against individual trader remains active); and
2. *CFTC v. American Electric Power Company, Inc., et al.*, No. C2 03 891 (S.D.Ohio filed Sept. 30, 2003) (litigation pending).

Energy Enforcement Actions Filed And Settled

1. *In re Dynegy Marketing and Trade, et al.*, CFTC Docket No. 03-03 (CFTC filed Dec. 18, 2002) (settled; \$5 million civil monetary penalty);
2. *In re El Paso Merchant Energy, L.P.*, CFTC Docket No. 03-09 (CFTC filed March 26, 2003) (settled; \$20 million civil monetary penalty);
3. *In re WD Energy Services Inc.*, CFTC Docket No. 03-20 (CFTC filed July 28, 2003) (settled; \$20 million civil monetary penalty);
4. *In re Williams Energy Marketing And Trading, et al.*, CFTC Docket No. 03-21 (CFTC filed July 29, 2003) (settled; \$20 million civil monetary penalty);
5. *In re Enserco Energy, Inc.*, CFTC Docket No. 03-22 (CFTC filed July 31, 2003) (settled; \$3 million civil monetary penalty);
6. *In re Duke Energy Trading And Marketing, L.L.C.*, CFTC Docket No. 03-26 (CFTC filed Sept. 17, 2003) (settled; \$28 million civil monetary penalty);
7. *In re CMS Marketing Services and Trading Company, et al.*, CFTC Docket No. 04-05 (CFTC filed Nov. 25, 2003) (settled; \$16 million civil monetary penalty);
8. *In re Reliant Energy Services, Inc.*, CFTC Docket No. 04-06 (CFTC filed Nov. 25, 2003) (settled; \$18 million civil monetary penalty);
9. *In re Aquila Merchant Services, Inc.*, CFTC Docket No. 04-08 (CFTC Jan. 28, 2004) (settled; \$26.5 million civil monetary penalty);
10. *In re ONEOK Energy Marketing And Trading Company, L.P., et al.*, CFTC Docket No. 04-09 (CFTC Jan. 28, 2004) (settled; \$3 million civil monetary penalty);
11. *In re Entergy-Koch Trading, LP*, CFTC Docket No. 04-10 (CFTC Jan. 28, 2004) (settled; \$3 million civil monetary penalty);
12. *In re Calpine Energy Services, L.P.*, CFTC Docket No. 04-11 (CFTC filed Jan. 28, 2004) (settled; \$1.5 million civil monetary penalty);
13. *In re e prime, Inc.*, CFTC Docket No. 04-12 (CFTC filed Jan. 28, 2004) (a wholly-owned subsidiary of Xcel Energy, Inc.; settled; \$16 million civil monetary penalty);

14. *In re Barry Callebaut Sourcing, AG*, CFTC Docket No. 04-16 (CFTC filed May 13, 2004) (settled; \$25,000 civil monetary penalty); and
15. *In re Knauth*, CFTC Docket No. 04-15 (CFTC filed May 10, 2004) (settled \$25,000 civil monetary penalty).

In response to Senator Conrad's concern expressed during the hearing regarding a lack of regulation in certain Caribbean countries Chairman Newsome offered to provide the Committee with information on which countries are "blacklisted" by regulatory organizations such as the International Organization of Securities Commissions (IOSCO).

The bullets below identify various "blacklists" and the countries that are named on them. (IOSCO is engaged in an ongoing initiative to identify jurisdictions with which cooperation difficulties have been experienced by its members, but has not yet issued a list.) Further information is available on the websites provided.

- U.S. Treasury OFAC sanctioned countries list (<http://www.ustreas.gov/offices/eotffc/ofac/sanctions/index.html>) - Balkans, Burma (Myanmar), Cuba, Iran, Iraq, Liberia, Libya, North Korea, Sudan, Syria, and Zimbabwe.
- Current FinCEN Advisories regarding transactions involving the following countries (http://www.fincen.gov/pub_main.html): Burma (Myanmar), The Cook Islands, The Federal Republic of Nigeria, Nauru, The Philippines. Note that FinCEN issued and withdrew advisories regarding transactions involving the following Caribbean nations: Grenada, St. Vincent and the Grenadines, St. Kitts & Nevis, Panama, Dominica, The Cayman Islands, The Bahamas, and Antigua & Barbuda.
- Jurisdictions and Financial Institutions designated by Treasury under Section 311 of the USA Patriot Act as being of primary money laundering concern (http://www.fincen.gov/pub_fedregnotice.html): (1) Nauru (designated December 2002; proposed special measures April 2003); (2) Burma, Myanmar Mayflower Bank, and Asia Wealth Bank (designated & proposed special measures November 2003; final special measures April 2004); and (3) Commercial Bank of Syria, including its subsidiary, Syrian Lebanese Commercial Bank (designated and proposed special measures May 2004); Treasury designated Ukraine in December 2002, but rescinded that designation in April 2003.

FATF Non-Cooperative Countries and Territories (NCCT) List (http://www1.oecd.org/fatf/NCCT_en.htm): Cook Islands, Guatemala, Indonesia, Myanmar, Nauru, Nigeria, and Philippines. Caribbean jurisdictions that were named to and subsequently removed from the NCCT list: Bahamas, Cayman Islands, Dominica, Grenada, St. Kitts and Nevis, and St. Vincent and the Grenadines.

Responses to Written Questions Submitted for the Record

Questions from Senator Cochran

Question: *Do you believe (or does the Commission believe) there is sufficient opportunity for all parties affected by commodity futures markets to express their concerns when exchanges consider changes in trading hours or the terms and conditions applicable to commodity futures contracts?*

Answer: The Commission believes that there are sufficient opportunities for interested parties to express their views on exchange rule changes. While each exchange's rule-adoption procedure is unique, proposed rule changes are usually considered by a series of deliberative committees before final adoption by the exchange's board or a board subcommittee, and any substantive opposing views that were expressed about, but not incorporated into the proposed rule, must be disclosed to the Commission. Exchanges generally do not have formal procedures regarding the solicitation of member and non-member views on possible rule changes; nevertheless, it is in their own self-interest to ensure that their rules serve the needs of their market participants.

Prior to implementation, all exchange rule amendments must be submitted to the Commission, either for approval or on a self-certified basis. Under self-certification, an exchange may implement a rule amendment 24 hours after filing the amendment with the Commission, along with a statement certifying that the amended rule complies with all provisions of the Commodity Exchange Act ("Act") and the CFTC's regulations. A rule amendment that materially changes a term or condition of a futures or option contract based on an agricultural commodity enumerated in Section 1a(4) of the Act may not be self-certified if the amendment applies to contracts and delivery months which have already been listed for trading and have open interest. Such rule changes must be submitted to the Commission for prior approval. While not required by the Act or the Administrative Procedure Act, the Commission typically publishes these rule amendments for public comment for a period of fifteen days, and may extend the comment period if it is in the public interest to do so.

The Commission must approve a rule amendment unless it determines that the amendment violates the Act or the Commission's regulations. Although there is no formal comment period for self-certified rule changes, Commission staff goes through the same analysis to determine whether the amendment complies with the Act and regulations as it does when Commission approval is sought or required.

The Commission posts all rule certifications on its website, which provides the public with an opportunity to comment at that time. Commission staff takes into account any comments received. Under Commission Rule 40.6(b), if the Commission determines that a certified rule amendment does not comply with the Act, it may stay the effectiveness of the rule during the pendency of a Commission proceeding for filing a false certification, or a proceeding to alter or amend the rule pursuant to Section 8a(7) of the Act.

The certification procedure was established by the Commodity Futures Modernization Act of 2000 (CFMA), in order to permit exchanges to react quickly in a competitive and dynamic business environment. To date, since passage of the CFMA, the vast majority of all rule changes have been adopted via exchange self-certification.

Questions from Senator Conrad

Question: *I'd like to get the CFTC's reaction to a commentary written earlier this spring by Bob Kohlmeyer, a respected commodity analyst, about the growing dominance of managed funds in futures trading. I know the CFTC has heard similar concerns over the past many years, but I think that Mr. Kohlmeyer's observations are interesting because he's generally viewed as very market oriented, very pro-market.*

In a recent series in the newsletter Ag Perspectives, he concludes that "... managed commodity funds ... have come to be the most dominant factor in ... agricultural futures markets. [T]he correlation between daily fund activity, and daily price actions comes out at nearly 90 percent. ... The growth of fund trading and the relative decline of commercial interest seems certain to change the landscape for futures markets in a number of ways, some of which are already underway. ..." And he cites the example of the move toward electronic trading.

He concludes with this observation:

"As funds drive futures market price directions, and dictate market structure and how markets function, can any remaining commercial nature of these markets survive, or will it disappear? Delivering or stopping physical commodities has long been a source of market discipline. But it could become a redundancy since funds have no interest in doing either. The future of agricultural futures markets is becoming increasingly clouded. Futures markets in some form may continue forever, but they may not be the same markets that many of us learned to respect." And he adds that commercial firms, "simply do not need and therefore do not use futures markets to the degree they used to."

What is the CFTC's reaction to his statements, and what can the agency tell me about the CFTC's ability both to monitor who is trading and to preserve the original commercial function of these markets, which Mr. Kohlmeyer seems to think is at risk?

Answer: The CFTC's market surveillance program deals with trading by managed commodity funds no differently than it does the trading of any other trader. CFTC surveillance economists monitor on a daily basis the positions of all traders, including funds, who hold reportable positions. All positions at or above reporting levels must be reported to the CFTC on a daily basis. Reporting levels vary by market. For example, the reporting level for cotton is 50 contracts, the level for wheat and soybeans is 100 contracts, and the level for corn is 150 contracts. Through our market surveillance program, the CFTC works to ensure that futures market prices are not distorted by manipulation, and accurately reflect the forces of supply and demand. This helps to enable futures markets to perform their commercial function of providing a tool for accurate price discovery and effective risk transference.

Mr. Kohlmeyer has correctly observed the growth of managed commodity funds in futures markets and that their trading is often positively correlated with the movement of futures prices. He has, however, made connections and drawn conclusions that do not seem to be warranted. For example, the movement of the futures industry to electronic trading has not been caused by fund trading, but rather is a response to competitive pressures to employ technology to lower the costs of trading.

Managed commodity funds are an important factor in agricultural markets (as well as in other markets), and the size of their trading as a group has probably increased in recent years. Although there is no reason to believe that these traders trade collusively—and Mr. Kohlmeyer does not make that claim—many of them trade using similar technical trading systems (trend following systems) and, therefore, they tend to be on the same side of the market. For example, as prices trend higher they tend to be buyers, and as prices trend lower they tend to be sellers.

The CFTC is not aware of evidence to support Mr. Kohlmeyer's statement that commercial firms "simply do not need and therefore do not use futures markets to the degree they used to." In fact, the evidence seems to support the opposite conclusion. Open interest in many agricultural futures markets is at very high levels by historical standards. The table below shows the current open interest and commercial participation in selected agricultural futures markets compared to levels 10 years ago. Open interest has grown during these 10 years by 149 percent in corn, 33 percent in soybeans, 163 percent in wheat, and 38 percent in cotton. Commercial participation has increased by even larger amounts: 262 percent in corn, 72 percent in soybeans, 300 percent in wheat, and 61 percent in cotton. It should be noted that commercial firms primarily use futures markets to hedge price risks, and it is this need rather than the level of funds' participation in futures markets that determines their use of futures markets.

Commodity	2004			1994		
	Open Interest	Commercial Long Positions	Commercial Short Positions	Open Interest	Commercial Long Positions	Commercial Short Positions
Corn	631,781	332,980	414,175	253,374	91,294	114,903
Soybeans	201,050	93,418	118,070	150,616	33,163	89,799
Wheat	122,975	67,135	60,224	46,836	8,790	23,076
Cotton	81,883	59,497	33,243	54,120	22,805	34,726

Finally, we agree with Mr. Kohlmeyer's comment that "delivering or stopping physical commodities has long been a source of market discipline." However, the principal purposes of futures markets are as a forum for price discovery and for price risk transference. Neither commercial traders nor speculators normally intend to become involved in delivery. In this regard, there is no real difference between fund traders and other traders. However, delivery is the mechanism that ensures that cash and futures prices converge at expiration of the futures contract, and as such, it is a source of market discipline. While fund traders are unlikely to become involved in delivery, their presence in the market has in no way prevented commercial traders (or anyone else) from becoming involved in delivery, and they have not impaired physical delivery as a mechanism to ensure price convergence.

Question: *What do you see as the CFTC's biggest challenge going forward?*

Although it is difficult to identify any one particular issue as representing the Commission's biggest challenge going forward, keeping pace with the ever-increasing changes in the markets we regulate is certainly at the top of the list.

Some examples of these changes include an unprecedented growth in futures and options activity on U.S. exchanges over the last few years; new products, platforms and methods of trading, including the continued migration of trading activity from open-outcry to all-electronic trading from widely dispersed geographic locations; the transition from purely member-owned exchanges to publicly held trading facilities; the continued globalization of all financial markets, with linkages between U.S. futures exchanges and foreign counterparts operating around-the-clock and the concomitant need for effective cooperation and coordination among regulatory authorities and between regulators and markets; and the decoupling of the trading activities hosted by exchanges from the clearance and settlement functions performed by clearinghouses.

The increasing complexity of the markets we oversee and the rapidity with which the markets continue to evolve present the Commission with challenges on several fronts—from the need to maintain an up-to-date information technology infrastructure, as well as staff able to manage and analyze the information collected for anomalies in trading patterns, relationships, and strategies—to adapting policies in a way that will best serve the hedging and price discovery needs of a global marketplace while keeping important market integrity and customer protections in place.

In order to keep pace with the wide-ranging innovations in the marketplace the Commission must continue to be creative and flexible in its approach to regulation, and to be open to new ideas and technologies, as it strives to protect market users and the public from fraud, manipulation, and abusive trading practices, and to foster open, competitive, and financially sound commodity futures and option markets.

Questions from Senator Harkin

Question: *I understand the CFTC is under some budget pressure. This is troubling, coming, as it does, at a time when derivatives markets are experiencing record volumes and high volatility—conditions that provide opportunities for the unscrupulous.*

Do you believe the CFTC has the resources it needs? Has the CFTC been able to maintain consistent staff levels? Or have staffing levels been reduced the past few years?

I would like the CFTC to provide this Committee with an analysis and estimate of how much money and FTE's it would take to fully enforce the CFMA, as well as a historical analysis of its staffing levels and workload for the last five years for which information is available.

Answer: Every September, the Commission submits to Congress and the Office of Management and Budget (OMB) its best assessment of the resource requirements needed to effectively carry out its mission. When making this request, we are mindful that the Administration and the Congress must weigh our request against many competing budget priorities and—in the give and take of the appropriations process—the Commission may not always receive its full request. Last year the Commission requested for FY 2005, 583 FTEs and \$110.6 million. That said, we are very sensitive to the Congress and the Administration’s desire to be prudent with scarce budgetary resources, and understand that it is not always possible to fund every program at the requested level. Accordingly, we support the Commission’s budget request, as included in the President’s Budget for FY 2005, for \$95.3 million and 505 FTEs.

Staffing levels compared to year-end trading volume and appropriations since 1999 are set forth in the chart below.

Fiscal Year	Staffing Levels (FTEs)	Year-End Trading Volume	Appropriations
1999	567 (actual)	592,919,398	\$61,254,000
2000	556 (actual)	594,516,449	\$62,761,000
2001	546 (actual)	797,172,065	\$70,658,000*
2002	509 (actual)	1,064,459,963	\$73,700,000*
2003	521 (actual)	1,264,668,733	\$85,526,000
2004	497 (ceiling)		\$89,901,000
2005	505 (ceiling)		\$95,327,000**

*Emergency supplemental funds (anti-terrorism) provided an additional \$200,000 in FY 2001 and \$16,900,000 in FY 2002.

**President’s Budget Request

Although the CFTC has received increased funding during this time period while staffing levels have declined, funding has not kept pace with the huge increases in trading volume. Nevertheless, the CFTC has continued to meet the challenges of accomplishing its mission. Several factors have contributed to the Commission’s ability to do so, including the delegation of some tasks to the National Futures Association. The most important factor, however, has been the increased productivity of Commission staff. In some areas, such as surveillance, staff productivity has been bolstered by technology, and in others training has improved staff skills.

The most significant factor in improved productivity over the years, however, has been the retention of experienced staff and the ability to be more selective in the hiring of new staff. The ability of the Commission to attract and retain staff was significantly enhanced last year when the Commission implemented pay parity with other Federal financial regulators, which was authorized by Congress in the Farm, Security and Rural Investment Act of 2002. In FY 2003, Congress funded pay parity for part of the year and the CFTC implemented a 20% across-the-board pay increase to bring the agency in line with other financial regulators. In FY 2004, funding for the agency did not provide for the same number of staff at the same level of support as it did in FY 2003, which resulted in a drop of the staff ceiling to 497 FTEs. The staff ceiling

included in the President's Budget for FY 2005 is 505 FTEs. Thus, the implementation of pay parity is the primary reason for the reduction in CFTC staffing levels.

Although the Commission would prefer a higher staff ceiling, the Commission determined that it was more important, in the long run, to implement pay parity in order to reverse the trend of losing critically-skilled employees to the private sector and to other Federal financial regulators. This trend, if left unchecked, would have eventually left the Commission unprepared to perform its critical mission and by extension, place at risk one of the Nation's most innovative and competitive contributions to the domestic and international financial services industry. By implementing pay parity, the Commission dealt effectively with what had become a chronic management challenge and a wasteful drain on scarce resources. The costs and waste associated with double-digit attrition are significant and include lost productive time until a qualified replacement can be found; time spent in recruiting and interviewing potential new hires; and intensive and specialized training (with a three to four-year learning curve) required to educate new staff. Each of the above diverted resources away from the real job—protecting the public, the market users, and the markets. As illustrated by the table below, indications are that with the implementation of pay parity in April 2003, this trend has been reversed.

Fiscal Year	Full-Time Permanent Turnover Rate
1999	13%
2000	11%
2001	10%
2002	14%
2003	7%
2004	7% annualized

Question: *Have there been any problems you have run into in trying to increase oversight of retail, foreign currency exchanges?*

Answer: Prior to the CFMA, the Commission's authority to police retail foreign currency (forex) activity had been called into question due to differing court opinions interpreting the scope of the Treasury Amendment, a provision of the Commodity Exchange Act which excluded the inter-bank foreign currency market from the Commission's jurisdiction. Recognizing that this had created a gap in the law, Congress granted the CFTC explicit authority, through the CFMA, to prosecute illegal, off-exchange forex futures and options offerings to the retail public.

Following this important clarification of the law, the Commission launched an extensive enforcement initiative, which continues today, to root out and prosecute unscrupulous operators of fraudulent forex bucket shops. Since passage of the CFMA, the Commission has filed 63 forex enforcement actions, and has been awarded civil monetary penalties totaling over \$104 million, as well as restitution and disgorgement judgments totaling more than \$64 million. Many of these cases have resulted in additional criminal charges through the cooperative efforts of our Division of Enforcement and State and Federal criminal authorities.

The Commission's efforts in this area have also been bolstered by extensive cooperative efforts with the NFA, and the NFA itself has brought enforcement actions against member firms for misconduct in this area. In addition, the Commission approved rules adopted by the NFA last year that are designed to protect investors in the retail off-exchange forex futures and options markets by imposing tougher standards on firms that are NFA forex dealer members. Among other things, the rules require forex dealer members to take responsibility for the activities of any unregulated solicitors they may deal with.

While significant progress has been made in this area over the past several years, challenges remain. Forex scam artists are increasing in sophistication. In some cases, they continually move the locus of their operations to try to stay one step ahead of the authorities; in others, they attempt to evade the Commission's jurisdiction by claiming they are affiliated with otherwise regulated entities (some in foreign locations), or that the contracts sold are spot (and not futures) transactions. As with other types of illegal, off-exchange activity, the Commission anticipates that forex fraud will continue to be an integral part of the enforcement program that will require significant resources.